Inflation in the US Economy: It Is a Problem or Not?

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INFLATION IN THE US ECONOMY: IS IT A PROBLEM OR NOT?

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Abstrakt

Tento článek se zabývá stručnou analýzou vybraných makroekonomických ukazatelů ekonomiky Spojených států amerických a následně se snaží dovodit případný budoucí vývoj těchto veličin. Hlavním závěrem je skutečnost, že Spojeným státům může reálně hrozit riziko inflačních tlaků a tlaků na oslabení nominálního měnového kurzu.

Klíčová slova

Inflace, finanční krize, měnové agregáty, produkt.

Abstract

This paper provides brief analysis of selected macroeconomical indicators of US economy and tries to sketch out possible future development of these variables. The main conclusion is that United States may be really threatened by possible inflation pressures in the future, as well as by possible pressures on its nominal exchange rate depreciation.

Key words

Inflation, financial crisis, monetary aggregates, product.

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Introduction

It is known and generally acknowledged fact nowadays, that the last (and still ongoing) financial and consequent real economy crisis is crisis of mutual trust between subjects engaging in financial markets[1]. Commercial banks were too frightened to lend to each other and the liquidity, that very important factor for providing loans to the subjects in real economy sectors has dried up. Central banks all around the world have been trying to save what they can by pouring immense volumes of liquidity into literally frozen financial markets. In the course of history of Federal Reserve System (FED) is it "commonly" used tool for easing the stress of financial markets' agents. Providing liquidity to ease the situation and to recover mutual liquidity lending between subjects was used to solve so-called Black Monday 1987 event, when all financial markets all around the world literally crashed down. Liquidity-pumping was used as some sort of cure and vaccination against possible panic in the situation

[1] As Krugman (2007) states: *„Behind the disappearance of liquidity lies a collapse of trust: market players don't want to lend to each other, because they're not sure they'll be repaid.* […] *But what has really undermined trust is the fact that nobody knows where the financial toxic waste is buried.*

after the 11th September attacks on the World Trade Center. This money-printing in order to help (or save) financial markets to overcome these shocks, of course, significantly helped in creating roots of financial crisis which erupted in the 2nd half of the year 2007.

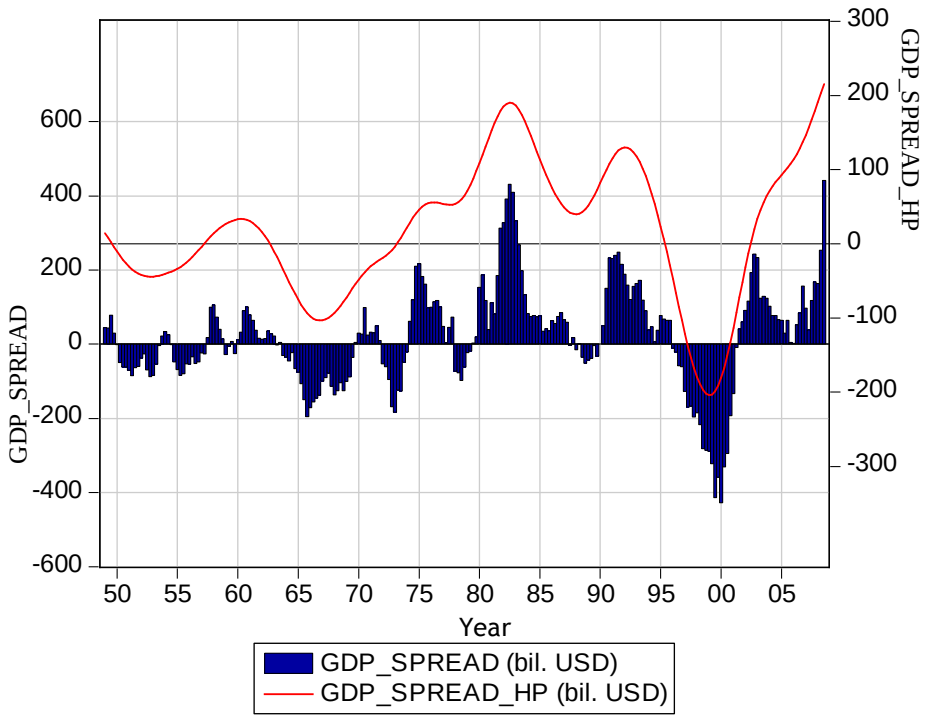
In the United States and consequently in many economies in the Europe, government agencies were forced to provide financial help to some of most seriously affected financial institutions. These efforts, of course, didn't come without costs. Enormous extent of governments' financial help caused large increase in deficit of fiscal (or public finances) budgets. It also seems quite likely, that this large quantity of money inserted into markets worldwide will result into serious inflation pressures. Thus, current economical recovery can be seen as weak and short-live one.

In this paper, we want to do a brief check of the situation in United States and make a guess, whether "bad" scenario, in terms of (too) large fiscal deficits and high inflation, written above is likely to happen in this economy.

Selected macroeconomic indicators and their development

The first factor we want to look at here is so-called real-potential GDP spread, i.e. the difference between real and potential gross domestic product – see Fig. 1.

Fig. 1 Difference between real and potential GDP of US economy



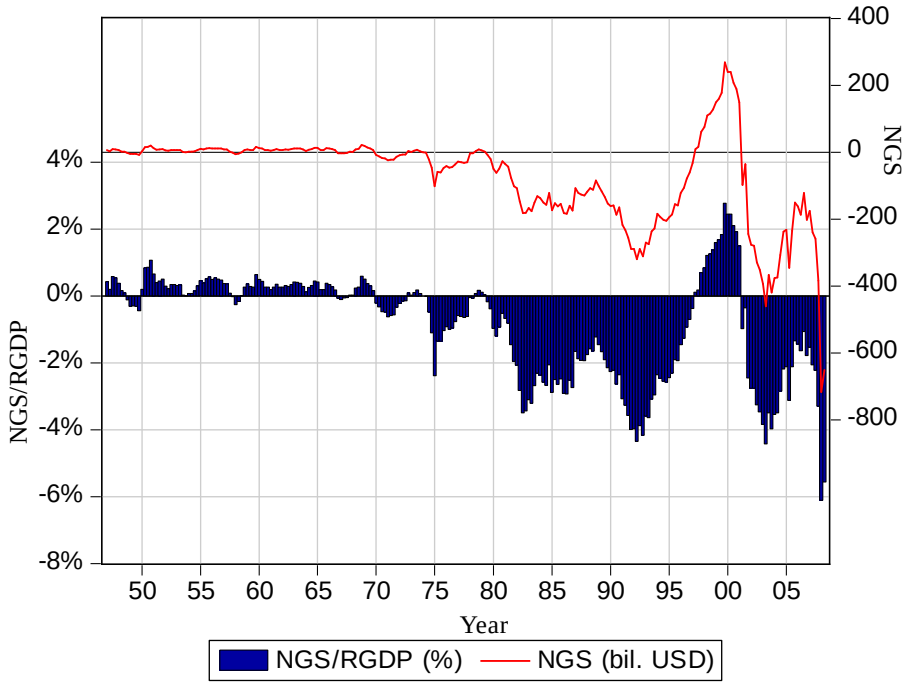
Quarterly data, seasonally adjusted. GDP_SPREAD – difference between real and potential GDP. GDP_SPREAD_HP is GDP_SPREAD filtered by H – P filter.
Source: FRED, own computations.

Fig. 1 provides us with some interesting information. First, we can see, that in the past the gap showed strong cyclical pattern and for the most of the years in the time period 1974 to 1996 the amount of real GDP was higher than its potential. Second, from the year 2001 there is

another period of the real GDP overhang. This fact, and also the development of the indicator are not so surprising when we take into account the low-interest rate monetary policy of the FED. Even when financial crisis was ongoing there was, and still is, quite large and growing positive gap between real and potential GDP. This may bring us to maybe a little provocative statement – real economy crisis is simply an adjustment of economy which has been overheated for a long time. The economy has been sustained in this "hot" state artificially by low primary interest rate monetary policy of FED.

Now we can turn our attention to another important factor – the development of net government savings – see Fig. 2.

Fig. 2 Net government savings

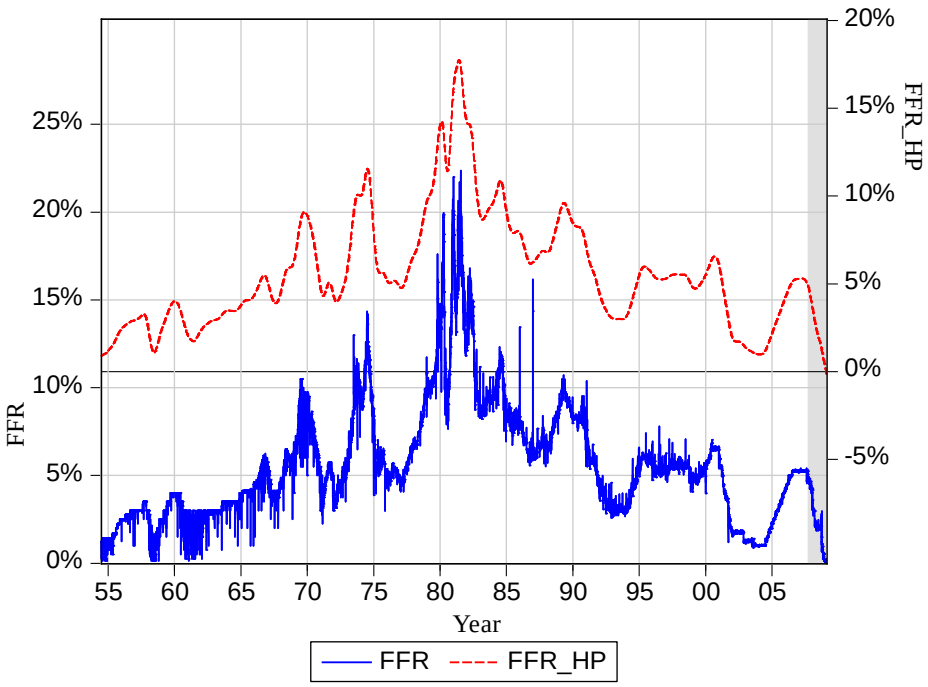


Quarterly data, seasonally adjusted. NGS/RGDP is net government savings (NGS) to real GDP (RGDP) ratio, expressed in percents.
Source: FRED, own computations.

We can see that except for a rather short period of years 1997 – 2001, the federal government budgets were running deficits for a long-term period of time – from 1970 to present. The reasons behind these deficits are well known. In the eighties it was direct result of so-called "reaganomics" – income taxes cut-down and armament industry spending increment played the main role. Deficits running in the last decade have been tied with war-efforts spending. And the rather steep increasing of deficits in year 2008 – 2009 is direct effect of massive government help provided to financial (and real) sector of the economy.

Just to illustrate the often stated fact, that the low interest rates monetary policy was the key factor behind all consequent financial and real economical difficulties, we show the Fig. 3 displaying the development of the effective federal funds rate. Notice the development in the period of 2001 to present.

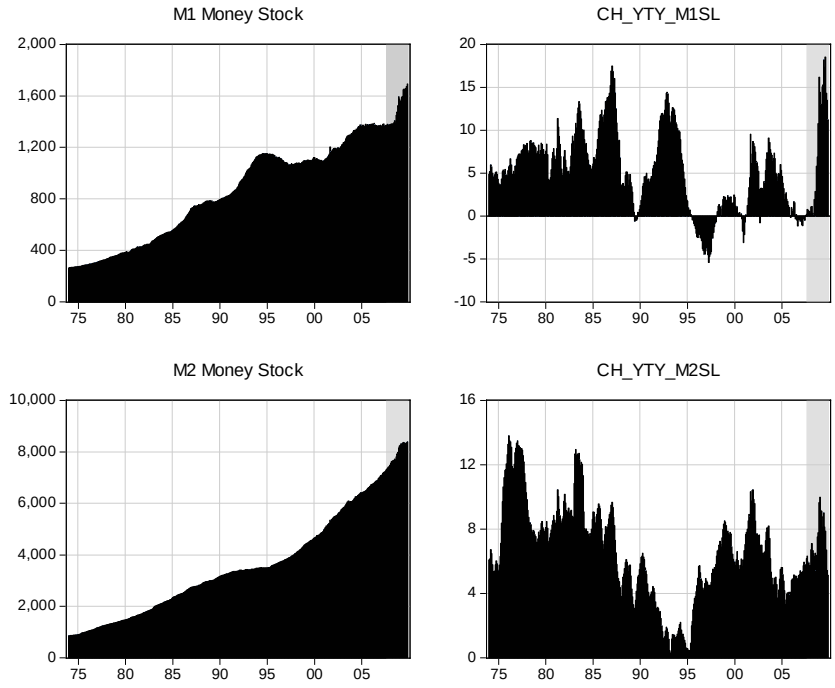
Fig. 3 Effective federal funds rate



Daily data. FFR is effective federal funds rate. FFR_HP is FFR filtered by H – P filter. Shaded area covers period between 2nd half of 2007 to present.
Source: FRED, own computations.

To see the fact, that current macroeconomic policy of FED provides solid grounding for future inflation pressures take a look on the Fig. 4, which shows development and year-to-year changes of monetary aggregate M1 and M2.

Fig. 4 Monetary aggregates and their changes

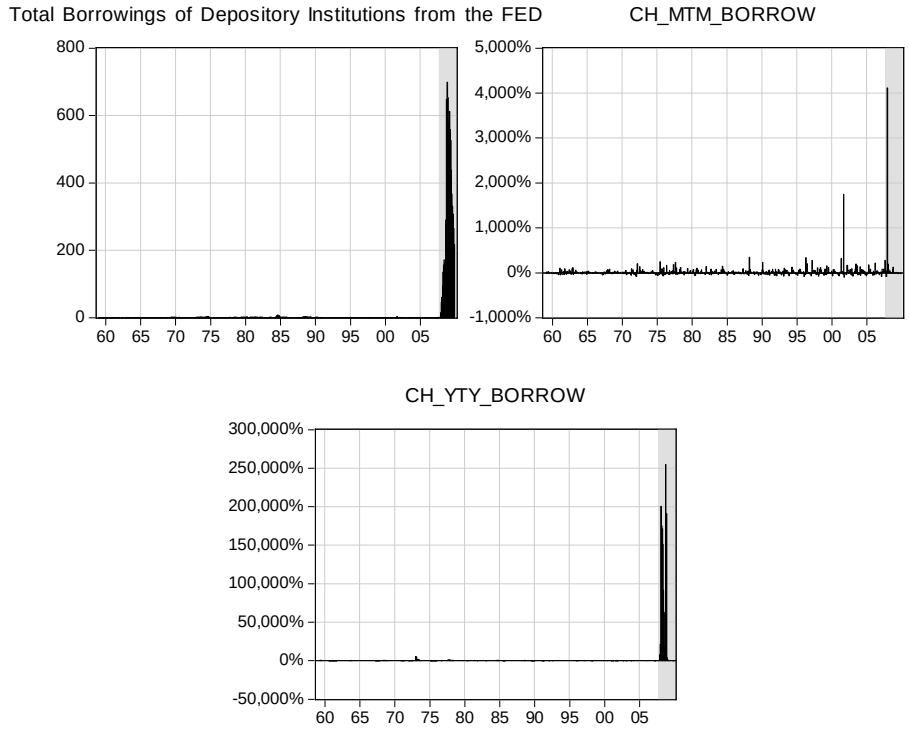


Monthly data, seasonally adjusted. CH_YTY_[variable name] is year-to-year percent change of M1 and M2. M1 and M2 are monetary aggregates, in billions of USD. Shaded area covers period between 2nd half of 2007 to present.
Source: FRED, own computations.

Especially in the case of M1 we can clearly see the rather steep increase of money supply, which may result in severe inflation pressures in the future.

To illustrate the unprecedented extent of liquidity injections provided by federal authorities see Fig. 5, which shows total borrowings of depository institutions from the Federal Reserve. We think that the Figure 5 is pretty self-explanatory.

Fig. 5 Total borrowings of depository institutions from FED and their changes



Monthly data, seasonally adjusted. Total borrowings of depository institutions are in billions of USD. CH_MTM_BORROW and CH_YTY_BORROW means month-to-month and year-to-year percent changes of the variable. Shaded area covers period between 2nd half of 2007 to present.
Source: FRED, own computations.

As Fig. 5 suggests, when financial and consequent real economy crisis erupted, financial institutions quite quickly came under the serious stress and need for additional liquidity, which had to be provided by federal authorities, namely FED. Again, this massive liquidity injecting may bring serious inflation pressures in the future.

Conclusion

In this brief analysis of selected macroeconomic variables of United States economy we tried to analyze some aspects of the current complex and by no means quite difficult economical situation of this economy.

We came to following conclusions. First, according to provided data the US economy seems to be still in “overheated” state. Gap between real and potential GDP is quite large and does

not diminish. From this point of view, those *efforts of federal authorities to revive and boost spending by providing cheap liquidity to financial institutions seems to be wrong and these efforts may result only in inflation pressures, in the long run*.

Second, possible future inflation pressures are indicated also by rather high increment of monetary aggregates, as indicated by Fig. 4. This development should not be surprising when one takes a look on the Figures 3 and 5.

Third, federal budget deficits are quite deep and show no signs of declining. Here, the war-efforts spending and financial help providing by federal government are to be blamed for this.

Very possible high inflation pressures in the future and high fiscal deficits and consequent federal budget's debt may endanger the stability and strength of nominal exchange rate of USD, mainly by lowering the confidence of foreign investors in US economy condition and future outlook.

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